

Confronting the Sub-prime Mortgage Crisis

Real estate professionals should know what to do in case a claim is filed

By **Todd J. Wenzel, Esq.** and **Jesshill E. Love III, Esq.**



No one can pick up a newspaper today without coming across another article about the sub-prime mortgage meltdown and credit crisis. It's a mess that has no doubt left many mortgage brokers and real estate agents wondering how to defend themselves should clients file disputes. There are a number of things agents and mortgage brokers can and should do to protect themselves.

The development and availability of exotic loan products over the last four to five years was driven primarily by consumer demand. Drove of consumers wanted to jump into the real estate market but could not afford to do so through conventional, FHA-backed loans. To meet that demand, lenders developed a number of products geared to the sub-prime mortgage market. Unfortunately, buyers were not always apprised of the hidden pitfalls associated with sub-prime loans.

Sub-prime loans were never designed to remain in place through the adjustment period. The plan was to get home buyers into a property at a monthly payment they could afford. To keep the payment low, a large portion of the monthly mortgage payment was deferred to the principal amount of the loan. Further, the low monthly payment that buyers counted on was only guaranteed through the adjustment period. At the expiration of that period, the loan rose to fully indexed rates.

We are now seeing a dramatic increase in lawsuits related to the sub-prime mortgage crisis. Consumers have alleged a variety of issues to support their claims, such as: The mortgage broker did not explain all the critical terms of the loan; The mortgage broker misrepresented the terms of the loan that, unbeknownst to the consumer, adjusted in two years and increased by 300 percent; The real estate agent breached his or her fiduciary duties by referring the consumer to a mortgage broker who procured a loan that the consumer would soon not be able to afford; All the real estate professionals involved in the deal lead the innocent consumer into this loan so they could make money, without regard to the financial impact on the consumer.

A broker of sub-prime mortgage loans will need to establish that he or she provided full disclosure of all the critical elements of the loan. The broker must demonstrate that the borrower was advised of at least the following three items: (1) the length of the interest-only loan and the date the loan was scheduled to adjust; (2) the amount that the monthly payment would increase to after the loan adjusted; and (3) the monthly household income needed on the date the monthly payment would adjust.

In some cases, consumers allege that their earning capacity was overstated, often times at the mortgage broker's suggestion. Some consumers have argued that the broker wrote in the monthly income or stated the monthly income the borrower needed to write onto the application. The brokers, on the other hand, likely relied upon the language above the signature on the loan application where the borrower attested that all the information provided in the loan application was true and correct under penalty of perjury.

Some consumers have been successful in arguing that the mortgage broker was the expert and duty-bound to adequately describe their monthly income and net worth. Therefore, if information on their monthly income was not accurate, the broker is to blame. The merit of this argument is extremely fact-dependant and varies from case to case.

If real estate professionals believe clients may soon default on sub-prime loans, they might consider contacting the lenders who approved their clients' loans to see if the lenders will consider renegotiating the loans to avoid defaults.

For all transactions that involved sub-prime loans, real estate professionals should get their files in order. If a notice of claim comes in, all paperwork (including e-mails) will be critical to defending such a claim. Assuming there is Errors & Omissions insurance coverage, the insurance broker should be notified immediately of the claim. Although the real estate professional can tender the matter directly to the broker or insurer, the assistance of counsel is highly recommended.

Many insurance policies include notification provisions that require the insured to provide notice of a claim within a defined time period. Assuming there are no insurance coverage issues, the carrier will either retain the counsel that tendered the matter or involve counsel of its choice to defend the real estate professional's interests.

It is yet to be seen if there will be a way to navigate out of this housing collapse without an extraordinary number of defaults. Much will depend on the flexibility of the lending market to absorb the fallout from the sub-prime meltdown. In the interim, however, it is critical that real estate professionals understand both the cause of the crisis and the requisite acts they must take to protect themselves from litigation until the crisis subsides. ■

Todd Wenzel and Jesshill Love are partners in the Real Estate Practice Group at the law firm of Ropers, Majeski, Kohn & Bentley. Wenzel is in the firm's San Francisco office and Love resides in the Redwood City, Calif. office. You may contact them at twenzel@rmkb.com and jlove@rmkb.com.